The Advisor

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ESTATE PLANNER'S TIP

Americans have nearly $15 trillion in IRAs and 401(k) plans – while that sounds like a lot, the average account for persons in their 60s is only $172,000. And half of all households with no retirement savings at all are headed by those between ages 45 and 65, according to the National Institute on Retirement Security. Clients who have not started in earnest to save for retirement should be encouraged to begin contributing, regardless of their ages. One way to do so is to use a dollar-cost averaging approach, particularly with many stock prices down. A regular program of monthly investments will boost yields when stock prices begin rising again. Clients should also take full advantage of available sheltered options. In 2016, the maximum contribution for 401(k) plans and IRAs is $18,000 and $5,500 respectively, with make-up contributions of $6,000 and $1,000 for those ages 50 and older. Finally, clients still working should add any raise or bonus received in 2016 into savings, rather than simply spending the added cash.

EARLIER, UNTAINTED WILLS PREVAIL OVER INTESTACY

Virginia Murphy executed six wills in the years prior to her death in 2006 at age 107. Starting in 1989, she left $150,000 to Jacqueline Rocke, a cousin and Murphy's only close relative, the residue of her nearly $12 million estate to Northwestern University medical school, and $50,000 specific bequests to her attorney, his legal assistant and her accountant. In her final will in 1994, Murphy left specific bequests of $500,000 to the medical school and $400,000 to Rocke. The three advisors each received $100,000 plus one-third of the residue.

The Probate Court found undue influence on the part of the advisors, but determined that because the revocation clause in the 1994 will revoked all prior wills, the residue would pass by intestacy. A search found 48 heirs, most of whom were unaware of their family connection to Murphy.

Rocke appealed the intestacy ruling, citing the doctrine of dependent relative revocation, which holds that where a testator makes a new will revoking a formerly valid will, if the new will is found invalid, the old will can be re-established on the ground that the revocation was dependent on the validity of the new will. The theory is that a testator would prefer an old, valid will to intestacy.

The Florida District Court of Appeals said the drafting of six wills in five years indicates Murphy's intent to dictate the disposition of her assets. Removing the effects of the undue influence by the advisors, the court found the testamentary dispositions in all six wills to be similar. Murphy appears not to have known her heirs. Therefore, the court ruled, to allow her estate to pass by intestacy "would usurp the repeated testamentary dispositions" she provided throughout her wills. The court found the revocation clause in the 1994 will to be invalid and reinstated earlier provisions, in which the medical school received $500,000, with $400,000 and the residue passing to Rocke in the "last uninfluenced residuary devise" Murphy made (*In re Estate of Murphy*, Case No. 2D14-4107).

SPOUSE GETS NO CHOICE OVER CHARITABLE BEQUESTS

Michael McShane left his mutual funds, checking accounts, stocks, bonds and cash to his wife, Gwendolyn, in his will. He left mutual funds, "up to $800,000," to his first wife, pursuant to a divorce agreement. McShane also left "up to" $250,000 from mutual funds, stocks, bonds and cash to the University of Wisconsin School of Business, $150,000 to the University of Colorado School of Business, $50,000 each to two other charities and $25,000 and $20,000 each to two cousins. He left the residuary estate to his wife, who was also the estate's executor.

PHILANTHROPY PUZZLER

Steve owns timberland that has been in his family for several generations. He wants to make a gift to his favorite charity of the right to cut the trees, but he wants to retain the underlying land to pass down to his children. He has asked whether he can deduct the value of the trees if he makes the gift.

Gwendolyn claimed that McShane's intentions were ambiguous because of the use of the "up to" amounts to the named charities and individuals. She argued that the mutual fund proceeds should be distributed to his first wife and the cousins in the amounts stated, with nothing going to the charities, saying the language was precatory. Although the value of McShane's estate was about $8 million, Gwendolyn expressed concern that she might not have enough money to survive if the charitable amounts were paid. The charities objected, saying they would not have been named in the will if McShane had not intended them to receive the bequests.

The Probate Court found that the "up to" language was not precatory and nothing gave Gwendolyn discretion over what the charities would receive. The "up to" language recognized that mutual fund values may go down and there might not be enough to pay everyone. The bequests were contingent on the securities having the necessary value.

The California Court of Appeals agreed, noting that under Gwendolyn's reading of the will, the charitable provisions would be inoperative, violating state laws requiring all words of an instrument to be given some effect and state policy favoring construction of a will to uphold charitable bequests (*Estate of McShane v. University of Wisconsin School of Business*, B261360).

ONE PARCEL, TWO DONEES

Albert Hadley's 2010 will included a devise of real property to his church. In March 2012, Hadley pledged to donate the proceeds from the sale of the property to Cheekwood Botanical Garden. Several days later, he signed a sale contract with Evelyn Winn that contained a mortgage contingency clause obligating Winn to notify Hadley if she was unable to obtain a mortgage within 21 days. Before the contingency period expired, Hadley died.

The Probate Court granted the executors authority to sell the property. The church

appealed, noting its specific devise in the will. Cheekwood intervened in support of the executors, who argued that under the doctrine of equitable conversion, Hadley's interest in the property terminated at the signing of the contract. The church countered that Hadley retained an interest because of the unfulfilled mortgage contingency clause. The court denied the church's argument and allowed the executors to sell the land. The Connecticut Appellate Court reversed and remanded the matter.

The Supreme Court of Connecticut agreed with Cheekwood that the mortgage contingency clause did not preclude equitable conversion because the parties intended the contract to be fully enforceable at the signing, subject only to possible termination if Winn could not timely obtain financing. The court determined that the parties intended the sale to go forward, noting that contract language called for the contract to "remain in full force and effect," unless Winn gave Hadley notice.

The court found that Hadley intended to redirect his bequest from the church to Cheekwood, noting a letter from Hadley stating that he wished to donate the proceeds from the sale of the house and that if the proceeds were not given during his life, Hadley's estate would be obligated to give the proceeds to Cheekwood. Equitable conversion occurred, the court concluded, and the sale should be allowed to proceed *(Southport Congregational Church-United Church of Christ v. Hadley*, SC19398).

DWINDLING INCOME CONSTITUTES GROUNDS FOR CHANGE

At Leon Chamberlin's death in 1999, he left bequests in trust to three churches, restricting investment of the funds to insured bank accounts and government securities. Net income was to be used for church maintenance.

In 2015, the churches petitioned to amend the restrictions, allowing them to invest in accordance with the New York Prudent Investor Act. The Surrogate's Court denied the petition, finding no unforeseen change in circumstances.

The Appellate Division of the Supreme Court of New York noted that the churches were not seeking to alter the purpose of the trusts or change the dispositive provisions. The equitable deviation statute allows a court to make changes that "will most effectively accomplish its general purposes, free from any specific restriction" where it finds that changed circumstances "render impracticable or impossible a literal compliance with the terms."

Chamberlin's intent was to provide funds from which the income generated could assist with maintenance costs of the physical property of the churches. In the current investment climate, the restrictions have reduced the income to "essentially negligible amounts," frustrating the purpose of generating maintenance funds. The churches were not seeking to alter the purpose of Chamberlin's testamentary provisions, but rather be granted limited additional authority regarding the investment of the funds. The court found the relief appropriate, reversing the Surrogate's Court (*In re Chamberlin*, 2016 NY Slip Op 87).

PUZZLER SOLUTION

In Rev. Rul. 76-331, the IRS ruled that a gift of land, where the donor retains mineral rights, was not a gift of an undivided portion of the donor's entire interest. Similarly, a gift of the right to cut the timber is a partial interest, for which Steve would not be entitled to a charitable deduction. He could, instead, use the land to fund a charitable lead trust that would revert to him or pass to his children. Depending upon how the trust was structured, he would be entitled to an income tax or a gift tax charitable deduction. The trustee could cut a sufficient number of trees each year to satisfy charity's payout.

PLANNING FOR THE "OTHER" TAX AT DEATH

The estate tax applicable exclusion amount is $5.45 million for 2016. As a result, only about 4,000 estates are expected to be subject to tax this year. But clients still need to plan to avoid a tax that affects estates of all sizes – the tax on income in respect of a decedent (IRD). Code §691(a)(1) provides that income earned before death but not received until after death is included in gross income for the taxable year received. The "taxpayer" for the IRD is either the decedent's estate, the person receiving the IRD income or the person inheriting the right to receive the income.

What assets generate IRD? The most notable are IRAs and other qualified retirement plans, but IRD also includes U.S. savings bonds, accounts receivable of a sole proprietor, renewal commissions of an insurance agent, payments due under an installment sale, royalties under a patent license and a final paycheck of an employee. Taxes on IRD can go as high as 39.6%, depending upon the income tax rate of the recipient or the estate.

A satisfying way to avoid the tax on IRD is to bequeath such assets to charity, which pays no tax on the receipt of IRD assets. In Ltr. Rul. 200336020, a decedent's estate included an IRA, the undistributed balance of the year's minimum required distribution and HH savings bonds with previously deferred income. The beneficiary of all these assets was the decedent's estate. After certain pecuniary bequests to individuals, the residue of the decedent's estate passed to three named charities.

Code §642(c)(2) provides that if an irrevocable remainder interest is transferred to or for the use of charity, there is allowed a deduction for any amount permanently set aside for charity or "to be used exclusively for religious, charitable, scientific, literary or educational purposes." The IRS ruled that the decedent's estate would include the value of the IRA, the required minimum distribution and interest on the HH savings bonds, but the amounts are considered gross income permanently set aside for charity and therefore deductible under Code §642(c)(2).

Careful planning is needed to assure that charitable bequests are properly structured to avoid the tax on IRD. The IRD assets should be left to charity either as a specific bequest or as a residuary bequest if charity is the sole residuary legatee. The IRS has ruled that where a decedent's living trust directed that a *pecuniary* amount be paid to charity and the trustee proposed to satisfy the bequest by distributing Series E and H bonds with unreported increments in value, the transfer would be considered a distribution of cash to charity and a purchase of bonds. The increase in value would be included in the trust's gross income (Ltr. Rul. 9315016). A *percentage* charitable bequest did avoid the tax on IRD where the executor had the right to make distributions in cash or in kind and to allocate assets to a particular beneficiary (Ltr. Rul. 200234019).

A bequest to charity need not be outright. The IRS has ruled that retirement plans could pass to testamentary charitable remainder trusts providing lifetime payments to a surviving spouse (Ltr. Rul. 9253038) or a child (Ltr. Rul. 9237020). While the tax on IRD is not avoided, it is deferred, passing through to the income beneficiary as payments are received. The IRS also ruled favorably on an IRA passing to charity in exchange for a charitable gift annuity to be paid to a named individual (Ltr. Rul. 200230018).

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